Office of Chief Counsel
Internal Revenue Service

memorandum

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DPLeone

date: June 25, 2002

to: Daniel J. Tallarico, Business Valuation Specialist
Bob Spinneweber, Team Leader

thru: James F. Schrmack, Case Manager, Group 1454

from: Associate Area Counsel (CC:LM:HMT:CLE:PIT)

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subject: [redacted], **Inc. and Subsidiaries - Year ended** [redacted] **$**[redacted] **claimed loss on sale/leaseback of** [redacted]; **U.S. Registration Number** [redacted]

This is in response to your request for advice received in this office on September 17, 2001. This memorandum should not be cited as precedent. This memorandum is subject to 10-day post review by our National Office and, therefore, is subject to modification. Please call our office at the end of this review period, or on or after **July 8, 2002**, to see if the advice has been accepted. Since this advice is subject to post review, please do not disclose the conclusions reached in this advice to the taxpayer until after the period for post review has expired. This discretion will prevent any misunderstandings in the event that the advice is modified in any manner by the National Office. Finally, in no event should a copy of this advice be provided to the taxpayer.

ISSUE

For the tax year ended February 28, [redacted], may [redacted], Inc. ("[redacted]") claim a $[redacted] ordinary loss for an alleged sale/leaseback of a [redacted]?[1]

ANSWER

The purported purchase of the [redacted] by [redacted] from [redacted] Corporation, with a same day, prearranged sale and leaseback of

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[1] [redacted], Inc., as common parent, filed a consolidated income tax return for a consolidated group, of which [redacted], Inc. was a member for the pertinent tax year ended February 28, [redacted]. Although this case has been opened in the name of the parent [redacted], the discussion herein will concern [redacted], Inc.

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the [redacted] to [redacted] shall not be respected for federal tax purposes. Rather, the $[redacted] paid by [redacted] Inc. was a capital expenditure under I.R.C. § 263, related to [redacted], Inc. restructuring or modification of the lease for the [redacted]. Accordingly, the $[redacted] can not be claimed as an ordinary loss, but must be amortized over the term of the lease as modified.[2]

FACTS

[redacted], Inc. ("[redacted]"), a [redacted] corporation and a wholly-owned subsidiary of [redacted], Inc. ("[redacted]"), a Delaware corporation, is in the business of transporting passengers to various locations. Service contracts are entered between [redacted] and its customers, and [redacted] provides [redacted] and contract operations. Part of its business is providing staffed [redacted] In order to meet these contracts, [redacted] acquires outright or leases numerous planes [redacted] from various sources. [redacted] will also operate aircraft owned by the customer.

The transaction in question concerns a $[redacted] ordinary loss claimed by [redacted] for the tax year ended February 28, [redacted]. The loss was claimed due to [redacted]'s purported [redacted] purchase of [redacted] Mfg. Serial No. [redacted] U.S. Registration Number [redacted], [redacted] model, (hereinafter [redacted]) from [redacted] for $[redacted], followed by the same day sale of said [redacted] from [redacted] to [redacted] Inc. (hereinafter "[redacted]") for $[redacted].[4] Prior to the [redacted] "sale"

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[2] According to the advance notice of proposed rulemaking regarding capitalization of expenditures relating to intangible assets, which was issued January 24, 2002, it is not anticipated that the new proposed regulations will affect this position.

[3] Please note that this aircraft is also identified in some of the documents as an [redacted] model. At the time of manufacture, [redacted] was the manufacturer's name. Currently the manufacturer is known as [redacted] (merger). Due to the varying descriptions of the aircraft, we have relied on the manufacturer's serial number ([redacted] to identify the aircraft when reviewing the underlying documents for the transaction in issue.

[4] The ($[redacted]) ordinary loss was reported on Form 4797, Sales of Business Property, Part II, line 10. However, the loss was not clearly identified on said schedule nor anywhere on the return. The description of the property sold given in Part II of the Form 4797 is only "aircrafts", with a response of "varies" given under the date acquired and date disposed of columns, while the figures provided for gross sales price, depreciation allowed or allowable and cost or other basis were gross figures, after

transaction in question, the [redacted] was leased from [redacted] to [redacted] under a [redacted] lease agreement, and was further leased from [redacted] to [redacted] under a sublease of the same date. [redacted] deducted as rent expense payments made to [redacted] under the [redacted] lease agreement covering this [redacted] Additionally, subsequent to the purported sale at issue, [redacted] continued to deduct as rent expense the payments made to [redacted] under the [redacted] lease agreement, but with the [redacted] lease amended by the [redacted] ("[redacted]") detailing a new [redacted] month term and a lower monthly rental amounts to be paid under the lease. In addition to the term and rent changes, the [redacted] also provided different purchase options. In other words, both prior to and after the purported [redacted] sale, [redacted] leased the [redacted] from [redacted] and claimed rent deductions.

Background on [redacted]'s use of the [redacted]

[redacted] indicates that it acquired the [redacted] to place it as "a revenue-producing asset under contract with [redacted] in [redacted]. The [redacted] was committing to a [redacted]-year contract with this piece of equipment and [redacted] could provide this service at a profit."

The title to the aircraft was held in the name of [redacted] ("[redacted]"). [redacted] negotiated with [redacted] to lease the [redacted]. [redacted] made two lease proposals to [redacted] for the [redacted], one in [redacted] and one in [redacted], based on a cost of $[redacted][5] and the current cost of funds, and subject to credit approval of [redacted], Inc. Simultaneously, [redacted] was negotiating with [redacted] to finance the acquisition of the [redacted] and, in [redacted], [redacted] received a commitment letter from [redacted] for the financing, in the form

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netting, for all of the disposed "aircraft" reported on that schedule. No background detail was provided on the return. During the audit, when detail was requested, the taxpayer provided a workpaper entitled "[redacted]", which detailed the disposition of [redacted] aircraft. Of the [redacted] aircraft, [redacted] aircraft were held for less than one year and it is the dispositions of those [redacted] aircraft which are reported on the Form 4797, Part II. Since there was ample room on the return to report each of these [redacted] transactions separately and to include all of the relevant details, it is clear that the taxpayer attempted to hide the ($[redacted] loss from a [redacted] that the taxpayer purportedly purchased and sold on the same day.

[5] This figure was represented by [redacted] to [redacted] to be the pay-off on the lease that the [redacted] was currently under since the [redacted] was apparently under lease to another customer during these negotiations.

of an operating lease, to acquire the [redacted]. [redacted] did not enter into a lease with [redacted] but entered into a lease with [redacted] for the aircraft. It is noted that [redacted] did have other leases with [redacted] and did not have any leases with [redacted].

On [redacted], an AC Form 8050-2 Aircraft Bill of Sale, dated [redacted], was filed with the Federal Aviation Administration (FAA), showing a sale from [redacted] (formerly known as [redacted], Inc.) to [redacted] Corporation ("[redacted]"). This filing was recorded by the FAA on [redacted], as Conveyance No. [redacted], and the [redacted] was registered with the FAA in the name of [redacted]. The [redacted] home airport at the time was at [redacted]. It is not known who operated the [redacted] prior to this transfer from [redacted] to [redacted], nor are the terms of this transfer known. It is assumed that, consistent with the negotiations between [redacted] and [redacted], [redacted] paid at least $[redacted] to acquire the [redacted].[6]

[redacted] is not related to [redacted] and is not related to [redacted]. Since the lease commitment was to [redacted] from [redacted] we do not know why the transaction was structured so that title to the [redacted] was acquired from [redacted] by [redacted].[7] Due to the negotiations between [redacted] and [redacted], however, we surmise that the purchase of the [redacted] by [redacted] from [redacted], and lease to [redacted], with further sublease to [redacted], was simply a way to structure [redacted] financing for the property.

a: [redacted] lease between [redacted] and [redacted].

Under a lease agreement, dated as of [redacted], [redacted] leased the [redacted] from [redacted]. The lease term was [redacted] months, with a commencement date of [redacted]. [redacted] has only supplied copies of the documents which were filed with the FAA, and the rental amounts, termination values, etc. were intentionally deleted as [redacted] and [redacted] deemed the information to be confidential proprietary information. [redacted] maintains that it does not have access to the information concerning the lease between [redacted] and [redacted] since [redacted] was not a party to the lease.

Although the actual figures were not disclosed, it was disclosed that the rental payments were calculated as a percentage of total cost

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6 [redacted] received a Lease Payoff Quote from [redacted], Inc. with a $[redacted] pay-off on the lease, with the last payment on the lease being received on [redacted], and the pay-off figure good until [redacted].

7 , (b)(5)(AC), (b)(7)a [redacted]

to [redacted], defined as [redacted]'s total cost of purchasing and causing delivery of aircraft (including all taxes, insurance and transportation costs). There is an absolute, unconditional obligation to pay the rent. The lease is a triple net lease.

Under the lease, [redacted] is prohibited from lending, assigning or subleasing the aircraft, without [redacted]'s prior written consent, except for the sublease with [redacted] which was specifically referenced as contemplated at the time of the execution of the lease between [redacted] and [redacted]. The sublease with [redacted] had to be expressly subject and subordinate to the lease between [redacted] and [redacted].

[redacted] disclaimed any warranties under the lease for the design or condition of the [redacted] asserting that it was not a manufacturer or dealer in similar aircraft, and had not inspected the aircraft prior to delivery and acceptance by [redacted].

Under the lease, [redacted] was required to give quarterly financial reports of its parent, [redacted] ("[redacted]"), to [redacted]. [redacted] also entered into a Guaranty Agreement with [redacted], dated as of [redacted] (copy not provided to agent).

The lease references a stipulated loss value schedule, although a copy was not provided. In the event of loss or default, the lease provisions somewhat protected the lessor from risk of loss since [redacted] was required to pay the stipulated loss value in the event of loss or default or, if there were insurance proceeds or sale proceeds after default, then [redacted] had to pay the difference between said proceeds and the stipulated loss values, if any. As to potential benefit of appreciation, if the insurance proceeds received exceeded the stipulated loss values, the excess was to be retained by [redacted], the lessee (which also is the party who had to pay the premiums), while any sale proceeds received in excess of the stipulated loss values would inure to the benefit of [redacted], the lessor.[8]

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[8] Although the schedule of stipulated loss values was not provided, it is described in the lease as being the cost paid for the aircraft by [redacted] multiplied by a stated stipulated loss value percentage as set out opposite the applicable rent payment number with respect to that aircraft. It is assumed that the stipulated loss value schedule, like the termination value schedule attached to the sublease between [redacted] and [redacted], showed declining percentages over the term. Accordingly, in case of a casualty, [redacted] was protected to the full amount of the stipulated value on the date of loss, almost in the nature of the protection enjoyed by a creditor holding recourse financing against a debtor. Thus, the lease provided [redacted] with protection against downside risk, which risk was borne by [redacted]. However, any value above the stipulated loss value, in the event of a sale, would inure to the benefit of [redacted] which

The lease provided that the parties agreed to treat the lease as a true lease for all purposes, and that [redacted] was the party entitled to claim depreciation on the [redacted] during the lease term. In that regard, [redacted] represented and warranted as follows:

[redacted]

Paragraph [redacted] of the lease contains a fair market purchase option, exercisable at the end of the lease term so long as the lease is not in default and [redacted] has fully performed all of its obligations under the lease. Exercise of the option requires a minimum of [redacted] days notice before the expiration of the lease term, with the sale being on an "as is, where is basis". The price, plus any applicable taxes and [redacted]'s costs and expenses, shall be equal to the then fair market value of the [redacted] as determined by an independent appraiser, but not to exceed the Total Cost shown on the Individual Aircraft Record ("IAR")[10], No. [redacted], for this lease. The appraiser

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means that [redacted] retained the potential appreciation under the lease.

[9] This representation does not seem to be correct. The [redacted] was a [redacted] with a [redacted] address for its home airport. Title was acquired by [redacted] from [redacted], another leasing/financing company, and the [redacted] was under lease at the time.

[10] The Individual Aircraft Record is filed with the FAA and, at this reference, summarizes the relevant lease terms. However, the actual filed copy, or the filed counterpart, intentionally deletes cost and pricing information as the parties deem it to be confidential. While the actual dollar amount is not given, the stated ceiling on the fair market purchase option

is to assume that the [redacted] is in the condition in which it would be required to be returned under the lease.[11] This is the only purchase option in the copy of the lease which was provided to the Internal Revenue Service. However, as in the case of the sublease discussed in the next subsection, it may be that there were additional purchase options contained in a schedule attached to the lease, but no schedules were provided to the I.R.S. so it is only a matter of supposition that there may have been additional purchase options.

The lease between [redacted] and [redacted], and the lease and delivery acknowledgment executed by [redacted], were recorded by the FAA on [redacted], as Conveyance No. [redacted].

UCC-1 financing statements, identifying [redacted] as the debtor and [redacted] as the secured party, were filed in [redacted],

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is the same as the Total Cost by which [redacted] first acquired the [redacted] This may seem like an unrealistic ceiling, since surely it would seem that the fair market value at the end of lease term would be less than when [redacted] initially acquired the [redacted] However, it may be that aircraft do not depreciate significantly over time. Aircraft are subject to comprehensive maintenance plans whereby they are, in effect, continuously rebuilt over time (all but the structure). Additionally, there is such a lead time for the purchase of new aircraft that there is a significant market for used aircraft. It is our understanding from talking with the agents, and their discussions with the taxpayer, that the value of an aircraft at any particular time is more closely tied to where the aircraft is on the detailed maintenance/replacement schedules (which seem to be based primarily on amount of use, in conjunction with time passed) rather than the overall age of the aircraft.

[11] This requirement was added by an addendum to the lease, executed solely to add this assumption to be used by the appraiser when determining fair market value. Paragraph [redacted] of the lease provides detailed requirements for the condition of the aircraft when returned. Among other conditions, the aircraft has to have a minimum of [redacted]% of the manufacturer's recommended remaining time available between overhaul of certain named components and, if such condition is not met, then the lessee has to pay to bring the aircraft up to that condition. The addition of the assumption under which the appraisal of fair market value is to be done demonstrates the relevance of cycle time when determining fair market value.

[redacted], [redacted], and [redacted][12]. The financing statements represent that the parties intend the transaction to be a "true lease", and that the financing statements are only filed for precautionary purposes.

In addition to the lease agreement, [redacted] assigned to [redacted], as collateral security for the payment of rent and all obligations under its lease with [redacted], all of [redacted] rights, title and interest to the Aircraft Lease Agreement dated [redacted] between [redacted], as lessor, and [redacted] as lessee (see below), including all such renewals and extensions of such lease (referred to as "sublease" or "User Lease"). The assignment represents that the term is for [redacted] months expiring [redacted] and the monthly rent is not less than $[redacted]. Notwithstanding the absolute terms of the assignment, [redacted] had no right to proceed against the User Lease or to collect rents etc. unless and until an event of default under the lease with [redacted] and [redacted] had occurred.

b. [redacted] lease (sublease) between [redacted] and [redacted].

The lease between [redacted] and [redacted] contained primarily the same terms as the lease between [redacted] and [redacted] and was, for the most part, identical to the lease between [redacted] and [redacted]. It will be referred to as the sublease herein. There were a few differences:

1. There was no requirement to provide financial reports of [redacted]'s parent, although [redacted] had to provide copies of its own financial reports quarterly.

2. [redacted] had no right to sublease or assign.

3. Instead of representing in the Tax Indemnity section that, on the date that the lessee accepts the aircraft on behalf of the lessor, the aircraft was new and unused, [redacted] only represents that on the date that lessee accepts the aircraft on behalf of lessor, "all the aircraft"[13] are in a condition acceptable to lessee.

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[12] [redacted], through [redacted], has provided its file copies, which are not marked as recorded. For purposes of this advice, it is assumed that the statements have been duly recorded.

[13] As indicated above, [redacted] and [redacted] had an ongoing relationship in which [redacted] provided financing for several aircrafts operated by [redacted]. There are references to an [redacted] Agreement, dated [redacted] which covers aircraft other than (but perhaps, by amendment, in addition to) the [redacted] the subject of this transaction at issue. [redacted] has

The main body of the sublease only had the same fair market value purchase option found in the lease between [redacted] and [redacted]. However, [redacted] to the lease provided this additional information[14]:

Total Cost: $ [redacted] (represented as amount paid to to [redacted] to release their interest in the aircraft)

Term: [redacted] months, with monthly payments of $[redacted] (excluding taxes) due beginning on [redacted], and on the same date of each and every month thereafter until fully paid

Purchase Options:

1) Month [redacted]: [redacted]

2) Month [redacted]: [redacted]

3) Month [redacted]: [redacted]

The Individual Aircraft Record for this sublease, and the acknowledgment of delivery, is found at AIR [redacted]. As with the lease between [redacted] and [redacted], the AIR [redacted] does not contain any of the costs terms. Furthermore, only the term of [redacted] is listed, the AIR does not detail the purchase options. The AIR indicated that the sublease was to commence on the date of the advancement of funds.

A schedule of Termination Values was also included as part of the sublease. The termination values were equal to the applicable percentage assigned to each month term ([redacted]% in Month 1, declining to [redacted] in Month [redacted] in [redacted]) multiplied by

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identified [redacted] aircraft leases with [redacted] entered into prior to the transaction at issue, as well as [redacted] leases entered into after this transaction. However, the earliest disclosed aircraft lease was dated [redacted]. Accordingly, we do not know the nature of the [redacted] agreement.

[14] As stated above, the [redacted] to the lease between [redacted] and [redacted] was not provided. It may be that there was a similar schedule in that lease, which provided not only the details of the Total Cost and monthly payment amounts, but also additional purchase options.

the original equipment cost ($[redacted]).[15] The rental payments due on date of termination had to be paid in addition to the termination value. The termination value as of [redacted] (month [redacted] was [redacted]% of $[redacted], or a total of $[redacted]. Month [redacted] was not a purchase option month.

The sublease, and sublease acknowledgment executed by [redacted], were recorded by the FAA on [redacted], as Conveyance No. [redacted].

c. The purchase/sale/leaseback transaction at issue.

[redacted].

[redacted].

[redacted]:

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15 [redacted], (b)(5)(AC), (b)(7)a [redacted]

[redacted]." [redacted]

[redacted]." [redacted].

On [redacted], a Partial Lease Termination Agreement was reached between [redacted] and [redacted], terminating the lease as to the [redacted] and releasing the [redacted] from the terms and conditions of the lease.

On [redacted], an Aircraft Purchase Agreement was entered between [redacted], as seller, and [redacted], as purchaser, whereby [redacted] purchased the [redacted] for $[redacted]. This amount is equal to [redacted]% of the $[redacted] Total Cost listed on the sublease between [redacted] and [redacted]. The [redacted]% is from the Termination Values schedule which is part of the lease between [redacted] and [redacted], and is the percentage of original equipment cost which was required to be paid if the lease terminated in Month [redacted], or in [redacted].

On [redacted], an identical Aircraft Purchase Agreement (except for price) was entered between [redacted], as seller, and [redacted], as purchaser, whereby [redacted] purchased the [redacted] for $[redacted]. When asked how the $[redacted] sales price was determined, and whether there were any appraisals, [redacted] provided the following response:

A) [redacted].

B) [redacted]

A copy of the desk top appraisal was provided. This valuation, dated [redacted], is reproduced as follows:

Year of Manufacturer - [redacted]	Average [redacted]	
Base price for the [redacted] [redacted] version	$	[redacted][16]
Air conditioning		[redacted]
TOTAL	$	[redacted]
[redacted] sale price to [redacted] [redacted] sales price to [redacted]	$	[redacted][17]
Loss on sale		([redacted])
Variance to Blue Book		([redacted])

Attached was a page from The [redacted] Blue Book, [redacted] [redacted] (which may explain the [redacted] value date even though the transaction was done [redacted]). The chart of the worldwide resale price ranges for the [redacted] version of this [redacted] before add on for any particular options, has a range with a low of $[redacted] (has an assumption that there was high time service lives for all of the [redacted] major components at the time of valuation) and a high of $[redacted] (has an assumption that there was low time service lives for all of the [redacted] major components at the time of valuation). Obviously, and as discussed above, where a [redacted] is in the cycle or maintainance cycle is critical to the value of the [redacted][18]

[redacted] , (b)(5)(AC), (b)(7)a [redacted]

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[16] The blue book range for [redacted] with major components at the [redacted] on the service lives was $[redacted] to $[redacted]. The $[redacted] of that range. See further discussion below in the text regarding the blue book.

[17] Based upon this desktop appraisal, if it is accurate, [redacted] would have not only provided "financing" for [redacted]% of the fair market value, but would have in fact provided "financing" in an amount $[redacted] in excess of fair market value.

[18] We do not know whether the assumption that the [redacted] was at [redacted] in its cycle is correct. Note that, if the [redacted] was more appropriately viewed as being in the [redacted] in its cycle, the value based on the blue book could have been as high as $[redacted].

(b)(5)(AC), (b)(7)a [redacted]

On [redacted], [redacted] received $[redacted] for the [redacted]

$ [redacted] wire transfer, [redacted], from [redacted]

[redacted] proceeds of a short-term loan ([redacted] days) from [redacted] to [redacted], which loan was timely paid by [redacted]

[redacted] from [redacted], purportedly representing the proceeds of the [redacted] sale from [redacted] to [redacted]

On [redacted], the following documents were filed with the FAA:

1. Partial Lease Termination Agreement dated [redacted] between [redacted] and [redacted] which terminated Conveyance No. [redacted] (the lease referenced in subsection a., above) (recorded by FAA on [redacted] as Conveyance No. [redacted]).

2. AC Form 8050-2, Aircraft Bill of Sale, dated [redacted], by [redacted] to [redacted] (recorded by FAA on [redacted], as Conveyance No. [redacted]).

3. AC Form 8050-2, Aircraft Bill of Sale, dated [redacted], by [redacted] to [redacted] (recorded by FAA on [redacted], as Conveyance No. [redacted]).

4. AC Form 8050-1, Aircraft Registration Application, by [redacted].

The Aircraft Bill of Sale for the sale of the [redacted] by [redacted] to [redacted] states as follows:

[redacted]

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19 , (b)(5)(AC), (b)(7)a [redacted]

20 (b)(5)(AC), (b)(7)a [redacted]

[redacted]

The lease, which the bill of sale indicates remained in full force and effect regardless of the purchase of the aircraft, and selling of the aircraft, by [redacted], was then amended. [redacted] the rent schedule, was amended to show the following:

Total Cost: $[redacted]

Term: [redacted]

Rent: $[redacted] (excluding taxes) per month, beginning [redacted]

Purchase Options:

1) [redacted]: [redacted]% of Total Cost, plus regular monthly payment and all other amounts owed

2) [redacted]: [redacted]% of Total Cost, plus as above

These terms were to commence on [redacted], so this was a new [redacted] month period and not simply a revised "rent" amount for the months remaining on the lease as originally entered into in [redacted]. In other words, as a result of the amendment, the lease term was longer (original term [redacted] months, with a new term of [redacted] commencing at month [redacted], resulting in a total term of [redacted] months), and the monthly rent payments due were lower. It is clear, however, that the monthly rent amounts were determined based upon the amortization of the total cost and we do not know how said amounts reflect the fair market rental for said aircraft.[21]

A new termination value schedule was also attached to the lease amendment. The entire schedule has not been provided, but the page that was provided indicates that [redacted] prepared it for the "[redacted]-refinance of [redacted]". As before, however, the termination values were shown on a monthly basis as a declining percentage of cost, a normal

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21 [redacted]

amortization schedule for debt. However, unlike a 100% finance, the termination value at month [redacted] was still at [redacted]% of the total cost, or $[redacted]. Finally, as stated above, the purchase options changed.

The agent asked [redacted] for an explanation of the pricing behind the "new" lease with [redacted]. The response provided is as follows [redacted]

> The underlying financial structure of the [redacted] lease:
>
> Payoff to [redacted] $[redacted]
> Cash contribution from [redacted] (paid to [redacted]) ([redacted])
>
> Lease Basis with [redacted] on [redacted] Lease $[redacted]
> (cash [redacted] paid to [redacted])
>
> Monthly Payment: $[redacted]
>
> Purchase Option:
> [redacted] month option $[redacted] [redacted]%
> [redacted] month option [redacted] [redacted]%
>
> Fair Market Value Option at [redacted] months
>
> The explanation in the drop in rates from the [redacted] to the [redacted] lease is that the interest rate environment was lower and the competitive environment was better for leases, as well as [redacted]'s financial strength from a credit risk standpoint.

[redacted] indicates that the decision to enter into this sale/leaseback was a management decision and, as such, there were no board minutes. At the time of the restructuring of the contract with [redacted] for the [redacted], management determined that:

[redacted]

d. Book versus Tax treatment.

Initially, for book purposes the taxpayer was amortizing the loss from the sale/leaseback transaction over the term of the lease as amended in [redacted]. It was stated that the sale was reported that way because the sale was between related parties, although on audit no relationship could be discerned. The audit team asked for an explanation of the book treatment.

In response, the taxpayer's accountants first verified that this was not a sale between related parties. Further, the accountants state that the book treatment was in error, that the loss should have been recognized currently for book too, and that the taxpayer's financial statements will be corrected to show the loss on this transaction. The accountants cite FASB Statement No. 13 Accounting for Leases, for the change in the position, representing that FASB Statement No. 13 provides "that any gain or loss on the sale portion of the [sale/leaseback] transaction should be deferred and amortized if the lease is an operating lease, except when the fair value of an asset involved in the sale and leaseback is demonstrably less then (sic) its carrying value at the time of the sale and leaseback, the transaction is considered complete and the loss is recognized currently." The accountants conclude that, since the sales price to [redacted] was $[redacted] less than the assets "carrying value", the loss should have been recognized currently on the financial statements. ([redacted] letter from [redacted], CPA to [redacted]).

DISCUSSION

The lease between [redacted] and [redacted] provides that it is a true or operating lease and not a financing lease. [redacted] , (b)(5)(AC), (b)(5)(AWP), (b)(7)a (b)(7)a , (b)(7)a The analysis which follows assumes, initially, that the lease between [redacted] and [redacted] was a true operating lease, as stated in the lease agreement between the parties.[22]

Based upon the taxpayer's representations, there was a drop in the value of the [redacted] an asset that was used in the taxpayer's business. Additionally, not only was there a drop in value of the

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22 , (b)(5)(AC), (b)(5)(AWP), (b)(7)a [redacted]

fair market value of the asset itself, it appears as if the new contract negotiated by [redacted] with [redacted] for the use of this [redacted] was not as lucrative as the previous contract with [redacted] for the use of this [redacted] Finally, interest rates were lower, [redacted]'s credit worthiness was improved, and the market was better for lease financing in [redacted] than the market in [redacted]. All of these items are stated in the taxpayer's [redacted] responses concerning this transaction, with all of these elements contributing to the taxpayer's desire to restructure the lease on the [redacted] in [redacted].

At this juncture, [redacted] was willing to offer an attractive financing package: the interest rates were lower and the purchase options would be more favorable for [redacted]. However, it appears that any financing would be limited to an amount closer to the current value of the [redacted] Accordingly, we believe that, to restructure the lease, [redacted] had to pay up-front the difference between the termination value on the old lease ($[redacted] and the lower amount willing to be financed by [redacted] ($[redacted]), or $[redacted]. The $[redacted] could be viewed as being in the nature of a lease termination fee. (There was no right to get out of the contract, in fact there was no "purchase option" in month [redacted] of the lease even though [redacted] purportedly assigned its "right" to purchase from [redacted] to [redacted] as part of this transaction).

Generally, lease termination fees are currently deductible as an expense under I.R.C. § 162, Rev. Rul. 69-511, 1969-2 C.B. 24, but only if no subsequent lease is entered into between the parties. U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998); Phil Gluckstern's Inc. v. Commissioner, T.C. Memo. 1956-9; Pig & Whistle Co. v. Commissioner, 9 B.T.A. 668 (1927). If a subsequent lease is entered into between the parties, the "termination fee" is viewed to be a cost incurred in entering into the new lease, or of continuing the first lease in modified form. Since leasehold interests qualify as capital assets, see Commissioner v. Golonsky, 200 F.2d 72 (3rd Cir. 1952), and the fee is considered to be related to the new lease, or the modified lease, it must be capitalized under I.R.C. § 263 and amortized over the term of the new or modified lease. U.S. Bancorp, 111 T.C. 231.

Amortization of the $[redacted] over the lease term was obviously not very attractive to [redacted] since it had to pay the money up-front. Accordingly, the parties structured the transaction as a purchase of the aircraft by [redacted] from [redacted] for the termination value listed on the lease between [redacted] and [redacted], and a simultaneous sale and leaseback of the aircraft from [redacted] to [redacted] for the lower "fair market value" on [redacted], with a resultant "loss" of $[redacted] incurred by [redacted] on the "sale".

The structured form of this transaction will not be respected for tax purposes because there was no real sale by [redacted] to [redacted]. At best, there was a sale from [redacted] to [redacted], but there was never any intent for [redacted] to become the owner of the property for more than a split second while title was then passed to [redacted].[23] As stated in the FAA filings regarding this transaction:

> [redacted]

While parties are free to structure their transactions to reduce their tax obligations, they cannot simply insert meaningless steps (absent tax considerations) to avoid the clear tax consequences of their transaction. It is not enough that the taxpayer could conceive a multi-step process to achieve the same result as renegotiation of the lease. Under the judicial step-transaction doctrine, an interrelated series of transactions will be treated as component parts of an overall plan rather than being evaluated separately. The step-transaction doctrine has been described as another rule of substance over form that "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result." Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). See also Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938)("A given result at the end of a straight path is not made a different result because reached by following a devious path."); Higgins v. Smith, 308 U.S. 473, 475-476 (1940); Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945)(courts must view a transaction "as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant"). Unnecessary, transitory and meaningless steps can be ignored if the steps are designed only to avoid tax liability and not for any other reason.

There are three distinct formulations of the step-transaction doctrine. The three formulations are as follows: (1) the end result test, (2) the mutual interdependence test, and (3) the binding commitment test. Under the end result test, a series of transactions are stepped together if they are prearranged parts of a single transaction intended from the outset to reach a specific end result. Penrod, 88 T.C. at 1429. The end result test focuses on the actual intent of the parties at the beginning of the series of transactions. Under the binding commitment test, a series of transactions will be

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23 [redacted], (b)(5)(AC), (b)(5)(AWP), (b)(7)a [redacted] The fact that the $[redacted] was paid to [redacted] and not to [redacted] does not alter the underlying substance of the transaction (i.e., a payment for a lease modification, amortizable over the term of the modified lease).

stepped together if there is a binding commitment to undertake the later steps. Commissioner v. Gordon, 391 U.S. 83 (1968). Under the mutual interdependence test, the separate steps are analyzed to determine if the legal relationships created by one transaction would be fruitless without the completion of the entire series of transactions. Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981). We believe the end result test will apply in this case, and can be used to ignore the meaningless, and very transitory, "sale" from [redacted] to [redacted]. Accordingly, applying the step-transaction doctrine, the transaction will be recharacterized as a sale from [redacted] to [redacted], with a modification of the lease between [redacted] and [redacted].

Even if the step-transaction doctrine does not properly apply, in substance the transaction should be treated as a modification of the existing lease regardless of the form of the transaction. [redacted] and [redacted] can not alter the fact that the substance of the transaction, when viewed as a whole, was a modification of an existing lease, and a payment related to said modifications, by the artifice of having [redacted] "buy" the aircraft from [redacted] and "sell" it to [redacted], while the lease between [redacted] and [redacted] remains in full force and effect. See, Gregory v. Helvering, 293 U.S. 465, 469-470 (1935).

It is well-settled law that a lease is a capital asset to the lessee. See, e.g., University Properties, Inc. v. Commissioner, 378 F.2d 83 (9th Cir. 1967); Fitzsimmons v. Commissioner, 37 T.C. 179, 184 (1961); Main & McKinney Bldg. Co. v. Commissioner, 113 F.2d 81, 81-2 (5th Cir. 1940); Baton Coal Co. v. Commissioner, 51 F.2d 469 (3d Cir. 1931). Expenses incurred in the acquisition or modification of a lease are also capital expenditures. See, e.g., U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998); Denver & Rio Grande Western Ry. Co. v. Commissioner, 32 T.C. 43, 51-2 (1959), aff'd on other grounds, 279 F.2d 368 (10th Cir. 1960) (expenses incurred to draft a lease assumption agreement); Lieber v. Commissioner, T.C. Memo 1993-391 (financial advisory fees paid to obtain lower interest rates on mortgages paid pursuant to leases).

Rev. Rul. 73-176, 1973-1 C.B. 146, considered the issue of the treatment of payments made in accordance with a lease modification agreement. There, the taxpayer-lessee entered into a 20 year lease for five floors of an office building which was then under construction. The rent was calculated on a per square foot basis. After executing the lease but before the building was completed, the lessee determined it needed less office space. The lessee entered into a modification agreement providing for a reduction in square footage and a corresponding reduction in rent. As consideration for the changes to the original lease, the modification agreement required the lessee to pay an amount of "additional rent" in monthly installments during the first five years of the lease. The revenue ruling concludes that the additional payments are capital in nature, because they constituted consideration for a release from lessee's future obligations to occupy more lease office space and pay higher rent during the lease term of 20 years.

Accordingly, whether the $[redacted] is viewed as a termination fee to terminate the prior lease, or a fee to allow modification of the prior lease, or as advance rent under the "new" lease, it is clear that the $[redacted] must be amortized over the life of the new lease and cannot be currently deducted as claimed by [redacted].

Finally, in the event that the lease between [redacted] and [redacted] should actually be viewed as a financing or capital lease instead of an operating lease, so that [redacted] should be viewed as the owner of the property all along, there is still no way for [redacted] to recognize the alleged drop in the value of the property for tax purposes in [redacted]. Fluctuations in the value of assets held by a taxpayer and the ability to renegotiate a more favorable rental rate due to changes in both the lease capital markets (i.e., interest rates and availability of capital) and the credit worthiness of the taxpayer can not be reflected for tax purposes without a realization event. Simply because an asset under lease with [redacted] fell in value does not mean that the "loss" can be recognized for tax purposes. <u>Cottage Savings Association v. Commissioner</u>, 499 U.S. 554 (1991). What we have in this case, economically, appears to be a "refinancing" of an asset that [redacted] used in its business both prior to and after the "refinancing", even if the form of the financing was an operating lease between it and [redacted]. A refinancing does not cause a realization event for tax purposes and, for the reasons discussed above, the taxpayers cannot insert a meaningless "sale" transaction into the refinancing in order to manufacture a realization event for tax purposes.

<u>CASE DEVELOPMENT AND RECOMMENDATIONS</u>

, (b)(5)(AC), (b)(5)(AWP), (b)(7)a

[redacted]

, (b)(5)(AC), (b)(5)(AWP), (b)(7)a

[redacted]

, (b)(5)(AC), (b)(5)(AWP), (b)(7)a

[redacted]

, (b)(5)(AC), (b)(5)(AWP), (b)(7)a

[redacted]

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